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Nos. 94-1119 and 94-1120

IN THE

Supreme Court of the United States

OCTOBER TERM, 1994

20TH CENTURY INSURANCE CO., *et al.*,
Petitioners,

v.

JOHN GARAMENDI,
INSURANCE COMMISSIONER, *et al.*,
Respondents.

CENTURY-NATIONAL INSURANCE COMPANY, *et al.*,
Petitioners,

v.

JOHN GARAMENDI,
INSURANCE COMMISSIONER, *et al.*,
Respondents.

On Petitions for Writs of Certiorari to the Supreme Court of California

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BRIEF OF RESPONDENT PREFERRED RISK MUTUAL INSURANCE COMPANY IN SUPPORT OF THE PETITIONS

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Respondent Preferred Risk Mutual Insurance Company (Preferred Risk) supports the Petitioners' requests for review of the California Supreme Court's unprecedented application of this Court's "takings" jurisprudence to the actions of the Respondent Commissioner forcing hundreds of insurers doing business in California to disgorge billions of dollars in insurance premiums.

Preferred Risk is a mutual company organized under the laws of the State of Iowa[1] and is licensed to do business in all the States. Preferred Risk's business is balanced between the personal and commercial lines of insurance. It is a "niche" insurer, recognized as one of the nation's premier insurers of churches, church colleges and universities and other church-related operations.

Preferred Risk is one of scores of insurers who joined as petitioners in the *Hartford Steam Boiler* case which was consolidated below with the *20th Century Insurance Co.* case. The California Supreme Court's decision establishes standards governing application of the Respondent Commissioner's regulations implementing the "rollback" obligations imposed on hundreds of insurers by Proposition 103, including Preferred Risk, which faces asserted liabilities amounting to over 7 million dollars.

The courts below were aware that the *20th Century Insurance Co.* case was a test case for the Respondent Commissioner's Proposition 103 rollback regulations and they approached the identification and analysis of the issues raised by the regulations in that context. Consequently, the decisions of these courts will have a preclusive effect on future consideration of those issues in administrative hearings and judicial proceedings involving other insurers.

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[1] Preferred Risk has no parent company. It is affiliated with Midwest Mutual Insurance Company, which has no parent company. Preferred Risk owns 88% of the stock of Preferred Risk Financial, Inc., an insurance holding company. Midwest Mutual owns 9% of the stock of the holding company; the balance of the stock is owned by a Swedish company, Ansvar Mutual General Ins. Co. and miscellaneous employee-owned retirement plans.

1. The California Supreme Court's interpretation of the Proposition 103 rollback regulations reflects a profound misunderstanding of the "end results test" of *FPC v. Hope Natural Gas Co.*

Preferred Risk agrees with Petitioners that the California Supreme Court has erred in interpreting this Court's opinion in *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) as meaning that the return the Commissioner's rollback regulations constitutionally must allow an insurer the opportunity to earn on its rates can be something less than its cost of capital. This error stems from the Court's misunderstanding of the "end result" test adopted by this Court in *Hope* as an alternative to detailed constitutional review of ratemaking methodologies.

The *Hope* Court described a constitutionally acceptable end result as "rates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed . . . even though they might produce a meager return on the so-called 'fair value' rate base." 320 U.S. at 605. Contrary to the opinion of the California Supreme Court, it is evident from this language that the *Hope* Court had no intention of abandoning "cost of capital" as an essential element of a minimally nonconfiscatory rate under the cost of service approach to ratemaking. However, not only does the California Supreme Court's misinterpretation of the *Hope* test free the Commissioner to impose confiscatory rollback rates on insurers, the formula approved by the Court for developing such rates virtually guarantees that the confiscatory results of the regulations will impact similarly situated and competing insurers irrationally, arbitrarily and unequally.

2. The objectives of the rollback regulations bear no relationship to identification of rates that are not unconstitutionally confiscatory

The issue presented by the decision below is not the adequacy of a hypothetical return on a synthetic rate base of a public utility. The issue here is the constitutionality of the State of California's attempt to devise a price fixing formula by which to force insurers to disgorge premiums paid them by insureds in the past under competitive market conditions.

Proposition 103 and the Commissioner's rollback regulations represent political judgments that California consumers were being charged too much for insurance and that insurers should not be allowed to retain premiums in excess of the minimum rate constitutionally permissible. Determining what that rate might be for historic periods of an enterprise's operations does not involve the speculation required to approximate a rate for a public utility on a prospective basis, even though all such ratemaking is constrained by the same principles of unconstitutional confiscation.

Catch phrases like "deep financial hardship" or "ability to operate successfully" may be useful for subjectively describing what might constitute a just and reasonable future return for an enterprise enjoying a natural monopoly, but they are worse than meaningless to the task of determining in hindsight what rate would have generated a fair and reasonable return for a company competing in the open market with hundreds of other enterprises.

The California Supreme Court's interpretation of the rollback regulations poses the dilemma alluded to by Mr. Justice Scalia in *Duquesne Light Co. v. Barasch,* 488 U.S. 299, 317 (1989) (concurring opinion):

> [W]hile "prudent investment" (by which I mean capital reasonably expended to meet the utility's legal obligation to assure adequate service) need not be taken into account as such in ratemaking formulas, it may need to be taken into account in assessing the constitutionality of the particular consequences produced by these formulas. We cannot determine whether the payments a utility has been allowed to collect constitute a fair return on investment, and thus whether the government's action is confiscatory, unless we agree on what the relevant "investment" is.

The California opinion leaves no doubt that the rollback regulations are to be applied with complete disregard for, and of, this constitutional predicate. As that Court mandates their application, the rates the regulatory formula will produce will bear no correlation to a "fair", *i.e.* nonconfiscatory, return on an insurer's capital investment because they misidentify the relevant investment.

Insurers encounter a wide range of risks—from underwriting and investment risks to catastrophe and credit risks—not all of which are related to premium volume in any given year. Consequently, premium to surplus ratios can vary widely between insurers writing even the same lines of business. The Commissioner's regulations, however, disregard these wide variations and impute artificial premium/surplus ratios to insurers for the purpose of setting rates. Indeed, some of the artificial ratios assigned insurers by the Commissioner would violate the regulatory requirements of some other State jurisdictions. Iowa, for example, forbids insurers to allow premium/surplus ratios to exceed 3/1 without approval (Iowa Ins. Regs. §191-5.5), which is lower than the artificial ratios attributed by the Commissioner to a number of lines of business of insurers for purposes of the premium rollback.

As explained in the petitions for review, establishing rates for the rollback period in the manner commanded by the California Supreme Court will result in insurance consumers in other States subsidizing insurance consumers in California. This is especially true in the case of mutual companies, whose surplus may be generated principally by profits in other States. A forced return of premiums paid by mutual policyholders in a State with a history of losses would amount to taking property belonging to policyholders of the mutual company in other States. This arbitrary treatment of a multistate insurer's capital and surplus has the potential to severely reduce that insurer's ability to respond to the legitimate needs and requirements of other States' policyholders and insurance regulators.

The solvency and financial regulation of an insurer is a matter primarily under the jurisdiction of the insurer's State of domicile. It is proper in this context therefore to measure the propriety of California's conduct not only by considering the consequences of the regulations within California, but what effect would arise if not one but many States adopted similar legislation. *Wyoming v. Oklahoma,* 502 U.S. 437, 112 S.Ct. 789, 800 (1992); *Healy v. Beer Institute*, 491 U.S. 324, 336 (1989). The rollback regulations infringe upon the rights of California's sister States to regulate insurers by permitting retroactive adjustment of expenses actually incurred by an insurer and superimposing on it an arbitrary premium/surplus ratio. It requires only a moment's reflection to realize the consequences of many States fixing insurance rates at a level insufficient to return an insurer's cost of capital on the rationale that the insurer's total earnings derived from its activities in all States will enable it to continue in business.

Limiting the amount of surplus that can go into the rate base as the Respondent Commissioner seeks to do would reward insurers who leverage their capital to write more and more premiums—a result contrary to what the National Association of Insurance Commissioners is striving to accomplish with its risk-based capital guidelines.[2] An insurer's surplus is available to support all claims and all policyholders at all times and in all locations. The Respondent Commissioner's attempt to allocate insurer surplus for the particular benefit of California policyholders could trigger a "land rush" among regulatory jurisdictions to claim similar advantage for their insurance consumers.

Under our system of constitutional federalism the respect required for the autonomy of the individual States within their respective spheres inherently limits each State's power to fashion economic regulatory schemes. *See Allied Stores of Ohio v. Bowers,* 358 U.S. 522, 532 (1959) (Brennan, J. concurring); *Metropolitan Life Ins. Co. v. Ward,* 470 U.S. 869, 878 (1985); *Healy v. Beer Institute, supra*. As interpreted by the California Supreme Court, the rollback provisions of Proposition 103 and its implementing regulations exceed these limits.

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[2] The National Association of Insurance Commissioners Risk Based Capital Model Act will require (beginning with the 1994 Annual Statement) an insurer to compute the amount of capital to support four broad risk elements encountered by each insurer group: asset risk; credit risk; loss reserve risk and written premium risk. The goal of these regulatory requirements is to help assure the adequate capitalization and solvency of domestic insurers. These requirements are in direct conflict with the arbitrary surplus caps in the Commissioner's regulations.

CONCLUSION

For the reasons stated herein, the petitions for writs of certiorari should be granted.

Respectfully submitted,

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